No. 00-979

Supreme Court, U.S.
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In The Supreme Court of the United States

In Re: Norman W. Shearin, Jr; Ann Shearin,
Debtors.

VANDEVENTER BLACK LLP,
Petitioner,

v.

STEPHEN L. BEAMAN, TRUSTEE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Did the Bankruptcy Court err in determining that the male Debtor's interest in a capital account in the law firm in which he was a partner and the portion of his year-end bonus which was earned pre-petition was property of his Chapter 7 estate and that the law firm should turn over these funds to the Chapter 7 Trustee?

2. Does the Fourth Circuit Court of Appeals' decision in the present case, reconcile the decisions of the Fourth Circuit with the decision of the United States Court of Appeals for the Seventh Circuit, in Boyer vs. Carlton, Fields, Ward, Emmanuel, Smith and Cutler, PA (In Re U.S.A. Diversified Products, Inc.), 100 F.3d 53 (7th Cir. 1995), thereby rendering this Court's consideration of this Petition for a Writ of Certiorari unnecessary?

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STATEMENT OF THE CASE

The Debtors, Norman W. Shearin, Jr. and Anne S. Shearin filed a voluntary petition under Chapter 7 of the Bankruptcy Code on July 12, 1996. At the time of the filing, the male Debtor was a partner in the law firm of Vandeventer, Black, Meredith and Martin, LLP, a Virginia partnership, (hereinafter referred to as "Law firm"). The Law firm had a written partnership agreement that was dated January 1, 1996 and executed by the male Debtor. In their petition, the Debtors listed an interest in the law firm partnership as an asset with a zero dollar market value.

On or about August 13, 1996, the Trustee began corresponding with the Debtor and the Law firm seeking information about Mr. Shearin's' interest in the partnership and property of the partnership.

On August 13, 1996, the trustee wrote to Charles Tucker ("Tucker"), the managing partner of Vandeventer, Black, Meredith & Martin, L.L.P. advising him of his appointment as trustee in the debtors' bankruptcy case. The trustee related information offered by the male debtor at his 341 meeting of creditors. Based on this, the trustee informed Tucker of his belief that the male debtor possessed an interest in the undistributed income of the law firm partnership, a share of partnership assets, and an ERISA qualified retirement plan. In this letter, the trustee requested documents relating to these assets.

On August 20, 1996, the Law firm responded by enclosing certain documents, including the partnership

agreement, and denying that the male debtor had any interest in undistributed profits of the law firm because there were no undistributed profits as of the date of the petition.

The trustee wrote another letter dated September 11, 1996, requesting more information regarding the undistributed profits. The trustee specifically inquired as to whether the male debtor had work in progress as of the date of the filing that might lead to "a distribution of profits to him at a later date." The trustee also objected to the Law firm's request that the documents "be kept confidential and not distributed to any person or entity."

The Law firm did not respond to the trustee's second letter. The trustee again wrote the Law firm on October 31, 1996 requesting a response within ten days. Because of an incorrect zip code, this letter did not arrive at the Law firm's office until November 15, 1996.

On November 27, 1996, the Law firm replied requesting that its confidentiality concerns be addressed before providing additional documents and information on the male debtor's compensation for fiscal year 1996. This letter was received by the trustee on December 2, 1996.

The Trustee learned in early January, 1997, that substantial distributions for compensation had been paid to the male Debtor by the Law firm some time in December of 1996. The Trustee thereupon initiated an Adversary Proceeding against the Law firm seeking a turnover of property of the estate, pursuant to §542(a) of the Bankruptcy Code.

Upon the filing of the bankruptcy petition, the

remaining partners in the law firm continued the partnership without adopting a new partnership agreement or making any organizational changes. In addition the male Debtor continued to participate in the new partnership. This reconstituted partnership assumed the obligations of the former. No changes were made in the way that the partnership's business was conducted. No changes were made in the manner or amount of compensation for the male Debtor. The male Debtor continued to fully exercise his duties and responsibilities as a full equity partner and, in addition, enjoyed all of the benefits and rights of a partner in the law firm.

Michael P. Cotter was a member of the law firm's management committee and explained at trial the procedure developed by the law firm to allocate profits among the partners. After the law firm divided the firm's profits into two portions, one objective and one subjective, each partner was assigned two percentages, one representing the objective determination and the other the subjective, to be applied to the respective portions of profits. Cotter further explained in particular the procedure for determining the male Debtor's allocation. Cotter testified that the bankruptcy filing of the male Debtor had absolutely no effect on the amount or manner of year-end distribution allocated to the Debtor.

Prior to the trial, the parties stipulated that the male Debtor generated income for the law firm in the amount of $276,229.00 between December 1, 1995 and June 30, 1996. For the entire fiscal year ending November 30, 1996, the male Debtor generated receipts of $322,443.00. The male Debtor's three-year average of receipts for the years 1994, 1995 and 1996 amounted to $548,545.00. For the fiscal year ending

November 30, 1996, the male Debtor received 3.01% of the objective portion of the profits and 5% of the subjective portion. The male Debtor received two checks, one in the amount of $62,494.00 in December of 1996 and another in the amount of $17,976.58 in January of 1997 from the law firm representing his portion of the year end profits for the December 1, 1995 to November 30, 1996 period. The male Debtor only netted $76,042.75 of the total disbursements.

According to the partnership agreement, each partner also possesses an interest in a capital account in the law firm. As of the date of the filing of the petition, the records of the firm showed the male Debtor's capital account to be in the amount of $28,844.10.

At the conclusion of the presentation of evidence, the bankruptcy judge held that the male Debtor's capital account in the amount of $28,844.10 constituted property of the estate and was subject to turnover by the Law firm. In addition, the Court entered judgment in favor of the Trustee against the Law firm in the amount of $52,133.64, representing that portion of the male Debtors' year-end distribution which was earned pre-petition and further ordered that the Law firm turn over this amount. On appeal, the United States District Court affirmed the Bankruptcy Court's decision. The Fourth Circuit Court of Appeals has affirmed the judgment of the District Court. The Trustee requests that this Court deny the Petitioner's request for a Writ of Certiorari to the Fourth Circuit.

REASONS FOR DENYING THE PETITION

The Respondent contends that it is unnecessary for this Court to review the decision of the Fourth Circuit Court of Appeals in the present case in that (1) the Bankruptcy Court correctly determined that both the capital account of the Debtor earned pre-petition and that portion of the male Debtor's year-end compensation distribution earned pre-petition constituted property of the bankruptcy estate; and (2) the Fourth Circuit Court of Appeals' decision in the present case resolves any supposed conflict between that Court and the Seventh Circuit Court of Appeals. It is unnecessary for this Court to review the well reasoned decision of the Bankruptcy Court, which has already been reviewed and affirmed by both the U.S. District Court for the Eastern District of North Carolina and the Fourth Circuit Court of Appeals.

I. THE MALE DEBTOR'S INTEREST IN A CAPITAL ACCOUNT IN THE LAW FIRM IN WHICH HE WAS A PARTNER AND THE PORTION OF HIS YEAR-END BONUS WHICH WAS EARNED PRE-PETITION CONSTITUTE PROPERTY OF THE BANKRUPTCY ESTATE.

The filing of a petition under Chapter 7 of the Bankruptcy Code creates a bankruptcy estate. Section 541 of the Bankruptcy Code defines property of the estate as "all legal or equitable interests of the Debtor in property as of the commencement of the case," regardless of the location of the property. 11 U.S.C. Section 541. It is well settled that a Debtor's partnership interests on the date of the petition become property of the bankruptcy estate. See, In Re

Antonelli, 4 F. 3d 984 (4th Cir. 1993). Under Virginia law, a partner's interest in a partnership includes his right to receive compensation and his right to receive his capital account. VA CODE ANN. § 50-24 (Michie 1950). In the case at bar, the parties stipulated as to the exact amount of the Debtor's capital account as of the petition date, the amount of income generated by the male Debtor for the law firm during the year of filing and the exact amount of year-end distribution received by the Debtor. After hearing testimony that the bankruptcy filing had no effect on the operation or constitution of the law firm, the Bankruptcy Court's task was to simply calculate that portion of the year-end distribution that was earned pre-petition. Ample evidence was presented either by way of stipulation or testimony to provide the Bankruptcy Court with the necessary information to perform that calculation. The Bankruptcy Court then determined correctly that these funds were subject to turnover by the Law firm.

The Partnership Agreement of the Law firm divides partners into 2 classes, equity partners and non-equity partners. The Debtor was an equity partner. Termination of a non-equity partner's membership in the partnership is addressed in paragraph 4 of Article III. It does not address issues of bankruptcy. However, there is no comparable provision regarding the termination of membership of an equity partner in the partnership. Paragraph 1 of Article IV requires a vote of 3/4 of all the partners to expel an equity partner but the agreement does not address the consequences of an equity partner filing a petition in bankruptcy. The agreement gives a partner rights and interests in partnership property and in the partner's capital account. Paragraph 6 of Article IV provides that a partner "shall receive such share of the partnership's net

profits, as shall, from time to time be determined by the Management Committee in accordance with the criteria in Article VI." Paragraph 3 of Article VIII provides that a partner shall be paid his capital account upon "voluntary withdrawal or retirement". However, the partnership agreement is silent as to the partner's rights in net profits and capital accounts upon the filing of bankruptcy.

The partnership is governed by Virginia partnership law in effect at the time of the filing of the petition and at the time of the distributions to the male Debtor. The parties stipulated that Virginia law is the applicable partnership law. Important tenants of Virginia state law include: (1) the property rights of a partner (§50-24); (2) the partner's rights to profits and surplus (§50-26); (3) upon assignment of a partner's interest, the assignee is entitled to receive the partner's share of profits (§50-27); (4) bankruptcy of a partner causes a dissolution (§50-31); (5) the right of remaining partners to continue the partnership (§50-37.1), and the obligations between the partners if the partnership is continued (§50-38).

Since the agreement is silent on the consequences of a partner's Chapter 7 bankruptcy, the Court must look to state statutory law and case law to determine the rights of the male Debtor in the partnership and to bankruptcy law to determine which of those rights become property of the estate.

Virginia partnership law provides that upon filing of a petition in bankruptcy by a partner, a partnership is dissolved. Va. Code Ann. § 50-31(d)(5). That does not mean, however, that the partnership was then terminated. The 4th Circuit points out the difference under Virginia law in the dissolution of a

partnership and the termination of a partnership in FDIC v. Hish, 76 F. 3d 620; (4th Cir. 1996), stating, at page 623,

The Virginia Uniform Partnership Act expressly distinguishes between a partnership in dissolution and one that has been terminated. VA. CODE ANN. § 50-30 (Michie 1950) ("On dissolution the partnership is not terminated, but continues until the winding up of a partnership affairs is completed."). Actual termination of the partnership occurs only after the assets held in the partnership's name are distributed and accounts between partners are settled. The Virginia Supreme Court has even held that after a lapse of more than twenty years, a partnership in dissolution was not terminated because the partnership assets had not been distributed and its affairs had not been settled.

Dissolution also does not equate to liquidation of assets. A partnership may either liquidate its assets or the remaining partners may choose to continue the partnership and settle accounts with the partner causing the dissolution. This distinction was noted In Re Cutler, 165 B.R. 275; (Bankr. D. Ariz. 1994) by the bankruptcy Court in Arizona. The Court stated, at page 278,

Section 31(5) of the U.P.A., codified in Arizona as Ariz.Rev.Stat.Ann. § 29-231(E), provides that the "bankruptcy" of a general partner causes the dissolution of the partnership. The dissolution of a partnership is not the same as its termination. Rather, the term simply means that the partnership in which the Debtor held an interest no longer exists in its former state, and that the affairs of that partnership need to be wound up. The winding up process does not necessarily mean

that the assets of the partnership must be liquidated, although that is one option. One common method of "winding up", contemplated by U.P.A. § 41, 7 is the reconstitution of the partnership by the remaining partners with the withdrawn partner retaining an economic but not a management interest in the new partnership.

The Arizona Court distinguished the rights of a withdrawing partner to participate in the governance of the partnership that continues or is liquidated and the rights of the withdrawing partner as an economic interest. In both the old and the continuing partnership in that case, the Court concluded that the Trustee "succeeded to the economic interest of the Debtor in the partnership pursuant to Section 541 (a)(1)." In Re Cutler, at 278. The Court summarized its holding by stating that "The Trustee is entitled to receive his full one-quarter share of all surplus and profits, if and when such surplus and profits are realized. The remaining partners are free to re-form the partnership and to continue it in business and to manage the business consistent with their fiduciary obligations". In Re Cutler, at 282. In the Chapter 11 context, the 4th Circuit has further held that general partnership interests become property of the estate, including both the economic interest and the right to participate in the governance and the management of the partnership. In Re Antonelli, 4.F. 3d 984 (4th Cir. 1993). The Antonelli Court further pointed out, at footnote 4, that "assignment of a partner's economic rights is permitted, but the assignee has no right to participate in management unless he is admitted as a partner.

A number of Courts have addressed the issue of whether various provisions of the Bankruptcy Code prohibit the

dissolution and termination of a partnership upon the filing of bankruptcy. Some Courts have distinguished between Chapter 11 and Chapter 7 cases. The Trustee in this case concedes that a dissolution occurred by operation of law upon the filing, primarily because of the unique nature of a law partnership. Nonetheless, the issue remains as to what interest of the Debtor passed to his bankruptcy estate. The Debtor's economic interest in the partnership is two-fold: 1) his right to receive compensation and 2) his right to receive his capital account. See Va. Code Ann., § 50-24. From the authorities cited above, those economic interests passed to the estate subject to the control of the Trustee. The Trustee's duty is to collect and liquidate those assets for the benefit of creditors. In the present case, the Debtors' law firm continued in a manner that was uninterrupted and not affected by the male Debtors filing of a bankruptcy petition in any manner. The partnership continued without adopting a new Partnership Agreement. The reconstituted partnership included the Debtor as an equity partner and assumed the obligations of the former partnership. No changes were made in the manner or amount that the male Debtor was compensated as a year-end bonus.

In their Petition, the Petitioner argues that no determination or distribution of year-end distribution or capital accounts could be made unless an accounting had been completed. The Bankruptcy Court correctly concluded in Beaman vs. Shearin that since the partners, including the male Debtor, elected to continue rather than liquidate and terminate the partnership, that an accounting was neither necessary nor appropriate. The male Debtor's interest in the partnership could be determined correctly as calculated by the Bankruptcy Court.

II. THE CHAPTER 7 TRUSTEE HAS THE RIGHT UNDER §542(a) OF THE BANKRUPTCY CODE TO RECOVER THE VALUE OF PROPERTY OF THE ESTATE AND THE LAW FIRM'S LACK OF PRESENT POSSESSION CANNOT BE A DEFENSE TO AN ACTION FOR TURNOVER BY THE TRUSTEE.

The Law firm is required by § 542(a) to turnover property of the estate to the Trustee. The language of the statute is clear, requiring

> an entity, other than a custodian, in possession, custody or control, during the case, of property that the Trustee may use, sell or lease under Section 363 of this title, or that the Debtor may exempt under Section 522 of this title, shall deliver to the Trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate. 11.U.S.C. § 542(a)

Likewise, § 542(b) requires "an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to or on the order of, the trustee ..." The only exceptions are set forth in § 542(c) and (d). Subsection (c) provides that one "without actual notice or actual knowledge of the commencement of the case" to escape the net thrown over property of the estate by § 542. Subsection (d) relates to life insurance companies that have no application in this case.

The Trustee must show "that: 1) during the case; 2) an entity other than a custodian; 3) was in possession, custody or control; 4) of property that the Trustee could use, sell or lease;

and 5) that such property is not of consequential value or benefit to the estate". Boyer vs. Davis, 193 B.R. 868 (Bankr. N.D. Ind. 1995).

1. There is no dispute of fact that the Law firm was in possession of the funds at the commencement of the case on July 12, 1996 and continuing until December, 1996 and January, 1997. The Law firm continues in possession of the capital account funds.

2. The Law firm is an entity as defined in 11 § 101(15) and is not a custodian as defined in 11 § 101(11) and there is no dispute with respect thereto.

3. There is no dispute that the Law firm was in possession, custody or control of the funds during the case.

4. The Bankruptcy Court affirmed by this District Court has determined in the companion Adversary Proceeding Beaman v Shearin, that the funds are property that the Trustee could use, sell or lease; and

5. That such property is not of inconsequential value or benefit to the estate.

Clearly, all of the elements required for the Trustee to prevail exist in this case and the Trustee has met his burden of proof in establishing this claim.

The statute and case law are clear that the only notice required to invoke the duty of turnover under § 542 is notice that a case has been commenced. The plain language of the

exception set forth in subsection (c) requires that the Law firm have "neither actual notice nor actual knowledge of the *commencement of the case concerning the debtor...*" emphasis added) The case of Boyer v. Davis, id., involved a Trustee's suit against a law firm for transferring a substantial sum of money from the law firm's trust account to the principal of a corporation that had filed bankruptcy. The case was heard first in the Bankruptcy Court cited above, and was then affirmed sub. nom. Carlton, Fields, Ward, Emmanuel, Smith and Cutler, P.A. v. Boyer, 196 B.R. 801 (N.D. Ind. 1996). As in this case, no one ever directly told the defendant law firm that the funds in its trust account were property of the estate. Two days before the funds were distributed by the law firm, the law firm received a letter from the trustee's counsel which "requested a status report on all matters for which Debtor had retained Carlton, Fields and instructed it to take no action other than informing all interested parties of the bankruptcy. In addition, one of the lawyers in the firm had spoken with the principal by telephone approximately two months prior to the distribution and was informed that the corporation had filed bankruptcy but that the funds held by the law firm belonged personally to the corporate principal. The Bankruptcy Court concluded that a reasonably prudent person would have inquired further before disbursing a substantial sum of money and that inquiry would have resulted in the law firm learning of the Trustee's claim to the funds held by it. In this case there can be no contention that the Defendant lacked notice of the Trustee's claim because of the plain language of the letters dated August 13th and September 11th, 1996 to Charles F. Tucker.

In addition, the exception of subsection (c) of § 542 requires that the Law firm act in good faith in order to prevail.

The Law firm cannot show a good faith belief that the Trustee had no claims against the funds distributed to the Debtor from the facts of this case. The fact that the law firm paid the funds to the Debtor does not relieve it of liability, for the statute requires delivery to the Trustee. Delivery to a corporate officer does not satisfy the statute when the corporation is the Debtor. Seidle v. Air Transport Leasing Company, 6 B.R. 157 (Bankr. S.D. Fla. 1980). Likewise, if there is a dispute as to whether a debt is matured, a mere denial does not avoid the duties under § 542. Corzin v. Rawson, 40 B.R. 167 (Bankr. N.D. Oh. 1984). Courts have also considered circumstances where the property alleged to be subject to § 542 rightfully belonged in part to the estate and in part to the debtor. Fitzgerald v. United States, 27 B.R. 514, (Bankr. Idaho 1983) considered the issue of a tax refund under those circumstances. The Court held the IRS had a duty to comply with § 542 and deliver the funds to the Trustee and specifically found, at 515, that "There is no requirement in the code that the Trustee make demand, obtain a Court Order, or take any further action in order to obtain a turnover of the estate's property." The Court found that § 542 imposed affirmative duties to turnover property. Likewise, in Georgia Pacific Corporation v. Sigma Service Corporation, 712 F. 2 962 (7th Cir. 1983) the Court found that even where the property might be subject to a constructive trust, the estate had an interest in the property which required it's turnover to the Trustee.

Courts have consistently held that an entity which transfers property to anyone other than the Trustee after receiving notice of the commencement of a case does so at its own peril and that judgment against said entity lies in favor of the Trustee in such circumstances. Courts have consistently held that the language in § 542(a) requiring an entity to account

for the property or "the value of such property" leads to said result. In Re: Hoffman, 51 B.R.. 42 (Bankr. W.D. Ark. 1985); Boyer v. Davis, id.; Carlton, Fields, Ward, Emmanuel, Smith and Cutler v. Boyer, id. In Redfield v. Peat, Marwick, Mitchell and Company, 105 B.R. 440 (N.D. Ill. 1989), the Debtor was a partner in the defendant accounting firm. At the time of the filing of the case, the debtor had a capital account, a profit account, a deferred compensation account and a 401(k) Plan account. After the entry of orders in one adversary proceeding regarding all of the accounts with the exception of the 401(k) Plan account, the defendant accounting firm transferred substantial funds from the 401(k) Plan account to the debtor at a time when the defendant knew of the bankruptcy case. Despite the lack of present possession, the court found that the plaintiff was entitled to judgment for the value of the property because the defendant accounting firm had been in possession of the property while the case was pending. "Pursuant to the foregoing authorities, since it knew of the pending bankruptcy, Peat, Marwick was under a duty not to allow the Debtor's request 'to obtain possession' of his 401(k) account (which on this record was estate property) in the absence of court leave. It did so at its peril. As a result thereof, it might be liable to the Trustee for the value of the account... Peat, Marwick was under a duty to freeze the 401(k) account and not permit debtor to gain control over it after Peat, Marwick received notice and knowledge of the bankruptcy case."

The Respondent contends that this Court should accept review of the present case in order to resolve a conflict between the decisions of the United States Court of Appeals for the Fourth Circuit and the decision of the United States Court of Appeals for the Seventh Circuit, Boyer v. Carlton, Fields,

Ward, Emmanuel, Smith and Cutler, P.A. (In re U.S.A. Diversified Products, Inc.), 100 F.3d 53 (7th Cir. 1996) ("Diversified").

11 USC § 542(a) provides that "an entity in possession, custody, or control, during the case, of property the Trustee may use, sell, or lease under § 363 shall deliver to the Trustee, and account for, such property or the value of such property. "11 USC § 542(a)." In the present case, the Fourth Circuit Court of Appeals correctly construed the language "during the case" to refer to the entire bankruptcy case, not just the Adversary Proceeding. This holding is in accord with the Seventh Circuit Court of Appeals' decision in Boyer v. Carlton, Fields. In addition, the Fourth Circuit Court of Appeals clearly and correctly distinguishes its earlier holding in Hager v. Gibson, 109 F.3d 201 (4th Cir. 1997). The Court points out that in the Hager case, the Fourth Circuit held that because Hager did not have possession of the money at any time, Hager could not, for that reason, be required to turn over any sums under § 542(a). Therefore, the decision below in the present case only serves to clarify and resolve any supposed conflicts with the previous decisions of the Seventh Circuit Court of Appeals and further with previous decisions of the Fourth Circuit Court of Appeals.

CONCLUSION

WHEREFORE, the Respondent respectfully requests the Court to deny the Petition for a Writ of Certiorari.

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